

## Foreign Exchange

## Developments & 2H Outlook

### Asia FX - Regional Overview

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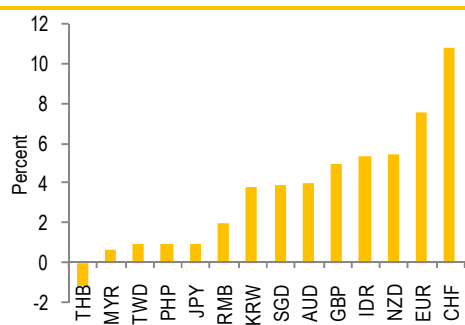
**Short Term View – Ebb and Flow of Global Risk Sentiment.** Shifts in global risk sentiment has continued to be a key driver in emerging market currencies year to date and particularly so over the past few weeks. Risk appetite seems to be waning now on the back of concerns of a global growth slowdown, following weak economic data from the US and China in the past month or so, uncertainty about Greece's second bailout, more recently contagion fears to Italy's banking system and disconcerting US political state of play with regards to raising its debt ceiling.

Nonetheless, in Asia, currencies such as IDR, SGD, KRW, CNY and MYR has appreciated around 4.4%, 4.0%, 3.72%, 2% and 0.6% respectively vis-à-vis the dollar in 1H 2011 (as at 21 June 2011). Indeed, if we look at the correlations between euro/commodities and Asian currencies – it remains significant, albeit diminishing somewhat over the past few months. Further concerns out of eurozone in the coming weeks and further indications of a decline in global growth leading to rising risk aversion flows, will pull down emerging Asian currencies vis-à-vis the dollar, CHF and JPY. However, there are signs that Asian currencies are holding their own in the face of risk aversion and euro weakness.

Our estimates show that regional currency strength has been supported by domestic policies and more significantly the trend appreciation on the CNY (lower mid-point fixing rate). In fact, even as global capital flows into Asia reaches its ebb, there is still some room yet over the next six months for further normalization in policy rates to occur in the region. The global interest rate differential story and the search for yield still remains and will be further enhanced in 2H 2011. Furthermore, if EU, IMF and ECB somehow manages to successfully kick the Greece can further down the road, global risk appetite may return, leading to inflows into emerging market currencies again.

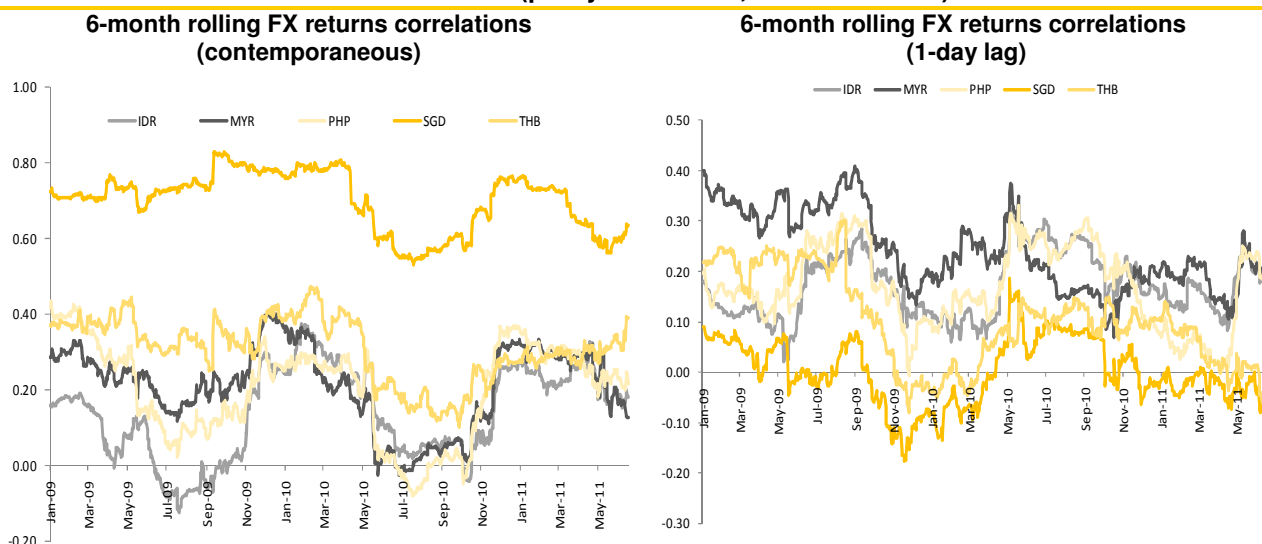
Another possible development that will support Asian currencies is the high likelihood that the US raises its debt ceiling before Aug this year. In the current risk regime switching mode, raising of the debt ceiling may raise risk appetite for Asian currencies. Domestically in the region, Asia faces the issue of balancing policy to achieve optimum growth and inflation levels. In the region, potential price pressures from rising wages and demand as well as dangers of rising commodity prices remain elevated, particularly in India, China, and ASEAN countries.

FX Performance Spot Returns (Year-to-Date)



Sources: Bloomberg (as at 21 June 2011)

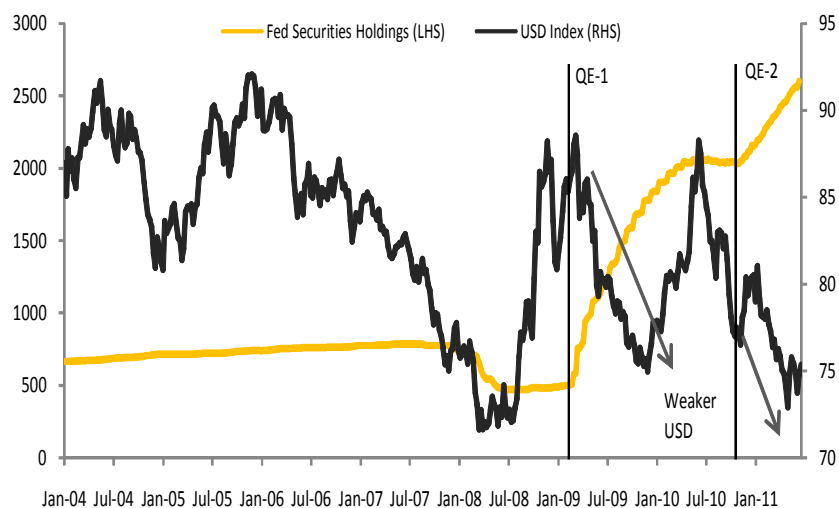
**Correlations ASEAN currencies with euro (proxy for risk-on, risk-off factors)**



Source: Maybank FX Research, Bloomberg

**US dollar index (basket of major currencies such as euro, JPY, GBP, CHF and CAD) has been rising since 5 May but whether or not the greenback can see a sustained rebound from here will depend on risk appetite and its influence as a safe haven.** The events out of the eurozone periphery would heighten market concerns about the solvency issue which the eurozone is facing and that will be key over the next few weeks or so. Raising of the US debt ceiling would inadvertently be equivalent to a loose fiscal policy and may likely lead to further dollar weakness and boost risk appetite.

**US Dollar Index Chart and QE**



Source: Bloomberg, Fed Reserve Board

**Asian currencies are expected to continue on a mild appreciation path over the next six months, although policy normalization may be delayed momentarily as the inflation-output tradeoff in policy-making slants towards growth risks.** At the same time over the next six months, there may be short term corrections, which may marginally weigh on the regional currencies, assuming no major upheavals out of the eurozone. At the moment, our view is that domestic fundamentals, interest rate differentials and possible CNY revaluation to tackle

inflation concerns, argue for that, but all bets are off, if Greece restructures or leaves eurozone and prolong the risk aversion sentiment.

**USD/SGD:** The SGD is expected to gradually appreciate to around 1.21 levels by end 2011. In the short term, the SGD has tended to correlate closely with swings in the EUR and is more susceptible to the risk-on risk-off behavior in the foreign exchange markets. It is hard to predict 'fat-tail' events that may emerge over the next 6 months but based on fundamentals and policy outlook on the back of inflation and output indicators, we expect the SGD to appreciate modestly towards the 1.20 levels.

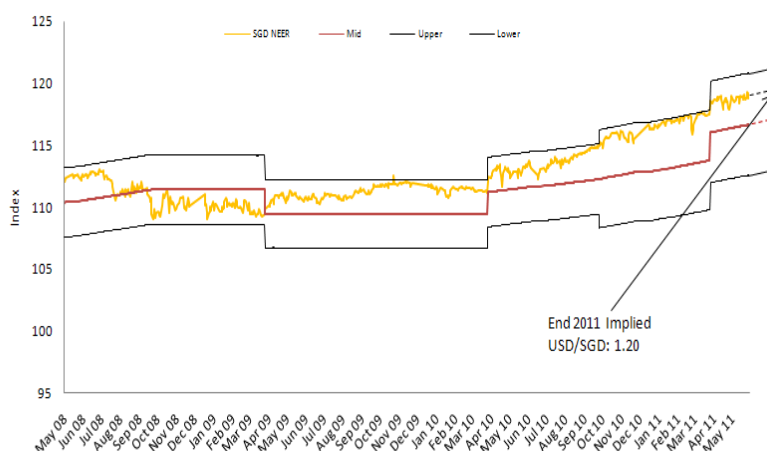
Given Singapore's exchange rate policy regime, any moves by the MAS in its upcoming Oct policy announcement may affect the SGD in the run-up and after the announcement. In April 2011, the MAS re-centred the S\$NEER policy band upwards in a pre-emptive move again given upside risks to inflation. The policy band was re-centred below the prevailing level of the S\$NEER on April 14, with no change to the slope or width of the band. At that juncture, the view was that despite uncertainty in the global economy, resilient regional demand and steady recovery in the advanced economies will continue to drive Singapore's economic growth and sustain its economic activity at a high level. MAS was concerned that inflationary pressures will remain strong given the high rates of resource utilization in the economy and the tight labour market could result in stronger wage growth and a greater degree of pass through to services costs, and eventually higher CPI inflation. Our view is that the SGD will remain on its appreciation path but we are unlikely to see any further revaluation in October as the pre-emptive tightening moves in April and Oct 2010 and Apr 2011 would have a restraining effect on economic activity and prices in 2H.

Given the recent non-oil domestic export numbers (NODX) released on 17 Apr which indicated a stronger than expected 7.8% y/y in May 2011, after 2.0% contraction in the previous month, it looks quite positive. However, if we look at the details particularly to our key final demand markets, the demand to eurozone and the US has fallen somewhat. For instance, NODX to EU27 and US declined by 1.6% m/m and 4.4% m/m on a seasonally-adjusted basis respectively even as the rest of the key markets recorded robust growth. What this means is that there may be some negative cascading effects on our manufacturers if a global slowdown happens. In the next few months, we may see NODX momentum slowing before recovering later in the year. Electronics exports may continue to be affected due to lacklustre demand on concerns of the sustainability of the global recovery, lingering effect from the Japan earthquake, and a unfavourable high base effect.

In view of the likelihood of slower growth in next few months and the increasingly uncertain external environment, we believe that MAS would keep the policy stance unchanged in the upcoming monetary policy statement in mid-October. It is likely that inflation probably had peaked in 1Q 2011, and while still at elevated rates presently, it is expected to ease in 2H this year. There are still some upside risks to inflation, due to commodities and a tight labour market situation, but increasingly, the risks are slanting towards growth. However, within the current policy band there is scope for the implied USD/SGD to appreciate towards the upper end of the 1.20-1.21 levels as it remains

in the upper half of the band factoring in further CNY appreciation and possible upside from global risk appetite in 2H.

### SGD NEER and Implied USD/SGD



Source: Maybank FX Research

**USD/MYR:** The MYR is expected to appreciate to around 2.95 levels by the end of 2011, as concerns about inflationary pressures is expected to lead to possible rate hikes in 2H 2011. Similar to SGD, positive correlations between euro and risk appetite means any negative news out of the eurozone periphery and global economy will weigh down on the MYR. However, one upside factor is if CNY is pressured to strengthen faster over the rest of the year. Recent CPI numbers out of China continue to indicate inflation at levels above 5% with credit creation declining but still at high levels. It has already raised reserve requirements and is expected to hike policy rates and/or possibly speed up its CNY appreciation over the next six months. Our estimation of regional currencies against the USD/CNY indicates a positive relationship between regional currencies and the renminbi. The MYR has tended to appreciate by around 0.4% whenever CNY appreciates by 1%. Although, recent estimates indicate that this relationship may have broken down, possibly due to heightened volatility and speculative outflows, we still hold the view that a gradual strengthening CNY (with a low likelihood of a revaluation) in 2H will be a major factor driving MYR appreciation.

### CNY and ASEAN Currencies

Currencies	Impact of 1% Chg in CNY	
	Jan 2010 - Current	Jan 2011 - Current
SGD	1.31**	1.42**
MYR	0.42**	-0.11
IDR	0.68**	1.99**
PHP	0.08	-0.26*
THB	0.43**	0.13*

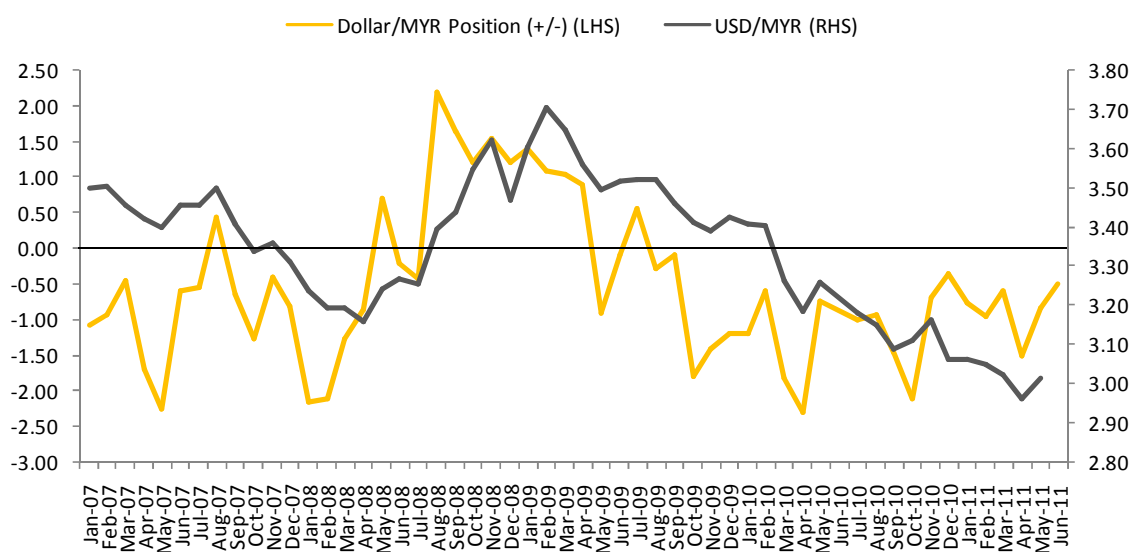
\*and \*\* indicates significance at 95% and 99% confidence level respectively. The above estimation controls for other factors affecting the currency such as other G3 movements.

Source: Maybank FX Research

To provide further support towards the Asian currency strength in the medium term, Reuters FX position survey data thus far still shows markets selling dollars for Asian currencies on average. The MYR is no

exception; however, there has been a slight moderation in dollar sales going into the middle of the year.

### USD/AXJ FX Positioning

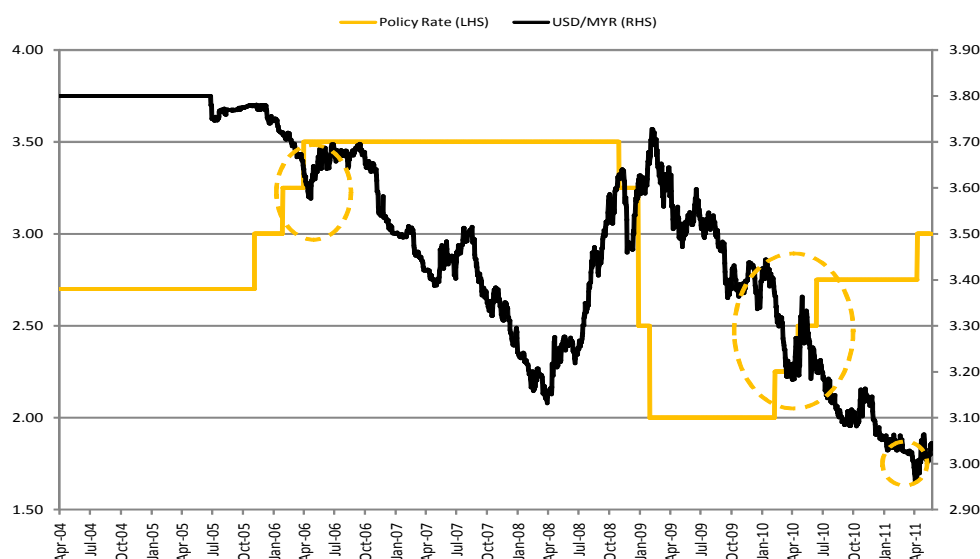


\*\* Please note: Negative Dollar/MYR Position indicates the extent of monthly short dollar/MYR positions amongst Reuters survey participants.

Source: Reuters, Maybank FX Research

Another major factor which may continue to support the MYR is the expectation that BNM will continue to raise a total of 75bps in the OPR to pre-crisis level of 3.5%. We assume further 25bps increases in Jul '11 and Sep '11 respectively after the 25bps increase on 5 May, against the backdrop of our in-house upward revisions in 2011 inflation rate forecasts to 3.4% (3% previously) and 2012 at 3.3% (2.9% previously). BNM continues to maintain a "hawkish" tone indicating that global commodity and energy prices will remain elevated and that domestic demand factors could exert upward pressure on prices in 2H 2011. In previous episodes of rate hikes since 2005, the MYR has tended to appreciate around 2-3% on average around the period of the 25bps policy hike announcements.

### Policy Rate Hikes and MYR



Source: Maybank FX Research, BNM, Bloomberg

**FX and Interest Rate Dynamics.** Barring no shocks globally, there is still some further room for interest rates to rise in Asia as it battles with inflationary pressures from not only rising food and commodity prices following recent droughts and floods in China etc., but also rising wage pressures from a tight labour market which may feed through into prices in 2H 2011. There are still a number of policy meetings left in 2H 2011 and it is likely that several rate hikes may emerge towards the latter half of the year for some regional countries so as to return to pre-crisis interest rate levels, even as global output slows down in 2Q and early part of 3Q 2011.

### Inflation, Targets and Policy Rates

Asia	Headline Inflation	Target Inflation (%)		Consensus Inflation Rate Forecast	Current Central Bank Policy Rate (%)		Consensus Policy Rate Forecast	Dates of Next Policy Meetings
	Rate (%)	Target	Actual	2011 (end period %)	Nominal	Real	Rate (end period %)	
China	5.5	-	5.4	4.70	6.31	0.81	6.75	Last one on 17 Apr 2011.
Indonesia	6.8	5.0 (+/- 1)	6.8	6.75	6.75	-0.05	7.50	9 June, 12 Jul, 9 Aug, 8 Sep, 11 Oct, 10 Nov, 8 Dec
Malaysia	3.0	2.5 (implied)	3.0	3.05	3.00	0.00	3.50	7 July, 8 Sep, 11 Nov
Philippines	4.1	4.0 (+/- 1)	4.1	4.10	4.50	0.40	5.00	16 June, 28 Jul, 8 Sep, 20 Oct, 1 Dec
Singapore	5.2	2 (implied)	5.2	3.20	-	-	-	Mid-Oct
Thailand	2.5 (core)	0.5-3.0 (core)	2.5 (core)	3.70	3.00	0.50	3.25	13 July, 24 Aug, 19 Oct, 30 Nov.
S. Korea	4.4	3.0 (+/- 1)	4.4	4.40	3.25	-1.15	4.75	10 June, 14 Jul, 11 Aug, 8 Sep, 13 Oct, 11 Nov, 8 Dec.

Source: Maybank FX Research, BNM, Bloomberg

### Asia's Policy Rate Normalisation May be Ebbing But Still Some Room to Move

	Current policy rate (%)	Period of monetary easing	Total rate cuts (bps)	Has the CB begun interest rate normalization and by how much (bps) ?	Next Policy Meeting	Policy rate end-2010 (%)	Policy rate expected end-2011 (%)
<b>Malaysia</b>	3.00	Nov 08-Feb 09	150	Yes (100bps)	7 July	2.75	3.50
<b>Indonesia</b>	6.75	Dec 08-Aug 09	300	Yes (25bps)	12 July	6.50	7.25
<b>Thailand</b>	3.00	Dec 08-Apr 09	250	Yes (175 bps)	13 July	2.75	3.25
<b>Philippines</b>	4.50	Dec 08-Jul 09	200	Yes (50bps)	28 July	4.00	5.00
<b>South Korea</b>	3.25	Oct 08-Feb 09	325	Yes (150bps)	14 July	2.50	3.75
<b>China</b>	6.31	Sep 08-Dec 08	216	Yes (175bps)	June	5.56	6.75
<b>Hong Kong</b>	0.50	Oct 08-Dec 08	300	No	-	0.50	0.50

Source: Maybank FX Research, BNM, Bloomberg

**USD/CNY:** Recently markets have again become heated up about the possibility of the PBOC increasing the CNY trading band, in this case from  $\pm 0.5\%$  to  $\pm 1\%$ . In recent weeks, senior SAFE official Guan Tao had recommended that the yuan's trading band be expanded (*Bloomberg, 7 June 2011*). At this juncture, it is difficult to indicate with certainty whether this will happen but with inflation remaining high, PBOC could use an additional tool. From a political angle, it may be highly unlikely for the band to be widened given past shifts were done before a major diplomatic event such as the 22-23 May 2007 Strategic Economic Dialogue.

Our view is that political focus on inflation risks will keep the appreciation trend intact until inflation has peaked slightly after mid-year. If any changes in CNY policy were to happen, it is unlikely to affect our forecast of 3-5% modest appreciation over the next 6 to 12 mths to end 2011 at around 6.37. However, it may be useful to note that in the last band widening in 2007, what followed was a more rapid CNY appreciation, and more intraday and higher implied volatility.

**USD/IDR:** We maintain our IDR appreciation towards below 8,500 to end 2011 at 8450, with the 8500 level seen as a perceived key support. Several reasons for this include the lack of resistance on IDR appreciation from exporters which have been doing well (Indonesia's textile sector has risen by an average 15.3% y-o-y in the three months to January after contracting by 15% from mid-2008 to September 2010), continued strength in the external sector, still room to move in terms of IDR strength on a trade-weighted basis and BI likely to be perceived to control inflation into 2H 2011.

Over the past quarter or so, and with the latest policy announcement in June, it looks likely that BI will tighten monetary conditions through IDR strength rather than policy rate hikes to balance the impact on domestic growth. One risk on the IDR would be if markets start to once again perceive BI as falling behind on inflation again, somewhat similar to the case in 2H 2010. But with the recent retreat in inflation and with prices likely to pick up again only in July/August due to the run up to Hari Raya festivities – this means BI will likely maintain its current stance and allow IDR to appreciate into 2H 2011. Add-on to the possibility of further capital inflows into IDR bonds leading to long IDR positioning by offshore entities, there could be increasing IDR upside.

If we compare the IDR volatility levels during the current risk-on risk-off environment, it remains relative stable compared to other regionals and looks unlikely to see sudden reversals in capital flows given stringent capital controls in place. At the same time, commodity prices, especially those produced in Indonesia, remain high and are likely to keep its trade surplus large. Finally, if you look at our estimations earlier, IDR's increasing sensitivity to CNY strength provides some upside to any CNY revaluation in 2H 2011.

**USD/PHP:** The PHP is expected to end 2011 at around 42.00 levels. Recently BSP kept both the policy repo and reverse repo rates on hold at 6.50% and 4.50% respectively. This is in line with our expectations. In our table earlier, BSP has cumulatively hiked rates by 50 bps since it began its tightening cycle in March this year. Instead, BSP raised the

reserve requirement ratio (RRR) on all deposits and deposit substitutes by 1% point, to be effective on June 24, as a preemptive move to counter inflation pressures from excess liquidity; this would drain P38 bn from the system. This move is also considered as a normalization of the easing measures during the global financial crisis (the RRR was cut by 2% points to 19% from 21% in end-2008).

Overall, BSP's stance remains moderately hawkish, though it is possible global growth concerns may have lowered its inflation projections compared to the previous two meetings. Indeed, BSP supported its decision in June by highlighting that its baseline inflation forecasts show a lower path and there are new signs that inflation expectations are leveling off. BSP retains its view that inflation risks remain and 2011 inflation would likely be seen near the upper end of its 3%-5% target range.

We expect BSP to maintain its tightening stance and continue with two 25 bps rate hikes by end 2011, largely through domestic wage cost price pressures as the economy improves. This further supports our view that PHP should see some appreciation in 2H 2011. Besides interest rate factors, we think the Philippine economy is seeing a strong external balance of payment position supported by remittance flows and services exports and this continues to prop up the PHP in the medium term, barring no shocks globally. Indeed, last week, Fitch ratings raised the country's debt rating to BB+ from BB, one level below investment grade. The Philippines had also reported a budget surplus of 61 mn pesos (\$1.4 mn) in the first four months of 2011, compared with a deficit of 131.80bn pesos a year earlier.

**EUR:** The next month or so will be quite volatile for the euro, and frankly, given the current EU political 'state of play' and global economic growth dynamics, it may be difficult to give very firm conclusions about what these latest developments out of periphery will mean. In an environment where eurozone periphery and solvency risk issues are getting so much attention, the markets have been shifting to a 'risk off' mode until developments improve. That has been the case for the past year or so since the Greek sovereign debt crisis began – "risk on" and "risk off" fluctuations.

Global growth concerns have also come to the fore recently with weaker than expected readings in the Eurozone May Manufacturing and Services PMI's suggesting growth is losing momentum. Coupled with the latest round of US data last week (Philly Fed, leading indicators and housing) as well as the recent China data (the HSBC Flash Manufacturing PMI fell to 51.1 in May from 51.8 in April, a 10 month low), these have led to further support the "risk off" argument and bearish stance on risky assets such as the euro.

Our view is that swings in risk appetite can be large fast and unpredictably furious. So, in the short term until the Greece situation is decided upon in June or as late as July, risky assets may see 'occasional' weakness leading to cautiously lower EUR, AUD, NZD, and gains in the USD, JPY and CHF. In addition, any further lack of commitment from the Greek authorities for further fiscal reform or political uncertainty in EU would likely hinder a resolution of its debt problem, weighing on the EUR. The EUR have thus far fallen on the perpetual concern of an imminent Greek restructuring and fears of

contagion as well as uncertainty in EU on saving Greece. The EUR fall also began when ECB signaled somewhat more dovish views than expected in the last policy announcement. In our view, contagion fears are still unjustified given that Spain and Italy's 2-year yields or differential with German bunds are still tolerable.

Over the next six months, even if Greece gets aid so as to make payments on its debts next month, such a lifeline may be temporary. Our concern is when Greece default on its debt, which is unlikely to be this year. If it happens, the event could trigger a global financial market selloff, with the possibility of banks ceasing to lend to each other and panicky investors unloading everything risky, from high-yielding currencies to stocks and lower-quality debt. The biggest beneficiaries will be the dollar, Swiss franc, other safe-haven currencies and gold.

Our view is quite optimistic for this year and that by end June, it should end at around 1.43 from 1.4165 in 1Q 2011, after a resolution to the Greek crisis in June/July, eventually rising to 1.46 levels by year end.

**USD:** Thus far, the dollar has appreciated on the back of global risk aversion due to renewed peripheral concerns and sell-off in commodities. However, we still think the structural reasons for the USD weakness are still valid. In particular, a very accommodative monetary policy stance remains (i.e. Bernanke remaining dovish during the press conference following the last FOMC meeting), escalating fears on US' fiscal position (the debt limit was reached on 16 May but extraordinary measures should keep the government operating until early August) and fairly robust global growth (despite recent concerns).

Overall, we do not expect the current weakness in EUR/USD to continue and maintain that it will rise albeit marginally over the next few months after July. We still view the underlying interest rate differential drivers to hold. We still do not feel that some form of Greek debt restructuring is necessary now and even if it is to happen, it will likely be next year – as current concerns of contagion to the other peripheral economies make it too costly or a 'no go' for the global financial system (especially if Spain is the next domino). Also based on historical experience in the past year and a half or so, the EU, if cornered to accept a near term restructuring, will likely make it market friendly. Even though, there are concerns that the eurozone banking system is exposed to Greek debt, the fact that most are held by German and French banks means any restructuring can be easily absorbed by their financial systems.

We also still hold the view that USD weakness will continue to be weighed by structural factors such as loose monetary policy and the continued rebalancing of the US economy even after QE2 ends in June.

**USD/JPY:** JPY is expected to see some strength amongst the safe haven currencies over 2H 2011 but fundamentally would most likely be driven more by US and risk aversion factors rather than Japan-related fundamentals in the near-term. Over the next 12 months though, domestic fundamentals should play a greater role as the US recovery stabilizes in 2012. Our JPY forecast remains in a tight range between 80-82 and ending 2011 at around 80.00.

**AUD/USD:** We continue to see some marginal upside for AUD even with the concerns of a slowdown in US as yield plays remain, with RBA indicating that it expects a hike soon (likely in July or August with another hike before end of 2011). Main support still continues from China's growth and commodities, but there are risks if commodities prices level off drastically from a global slowdown, an over-valued property sector and bank vulnerability to the eurozone risk. Coupled with the end of QE2, the US debt ceiling issues and concerns of a China slowdown, there are various factors that can weigh on the AUD. At the moment, our view is that the AUD is expected see some upside into Q3 before tapering off in 4Q to end the year at around 1.03-1.04 levels.

### FX OUTLOOK

	2011		2012			
	End Q3-11 f	End Q4-11 f	End Q1-12	End Q2-12 f	End Q3-12 f	End Q4-12 f
USD/JPY	80.50	80.00	81.00	84.00	85.00	86.00
EUR/USD	1.4500	1.4600	1.4400	1.3900	1.3600	1.3500
GBP/USD	1.6400	1.6500	1.6500	1.6400	1.6300	1.6100
AUD/USD	1.0500	1.0300	1.0200	1.0100	0.9900	0.9800
NZD/USD	0.8150	0.8100	0.8000	0.7800	0.7600	0.7500
USD/SGD	1.2150	1.1950	1.2000	1.2100	1.2150	1.2200
USD/MYR	2.9700	2.9500	2.9400	2.9600	3.0000	3.0100
USD/IDR	8500.00	8450.00	8550.00	8600.00	8700.00	8800.00
USD/THB	29.70	29.50	28.00	28.50	28.75	29.00
USD/PHP	42.50	42.00	42.50	43.00	43.50	43.75
USD/CNY	6.42	6.37	6.30	6.24	6.18	6.12
USD/HKD	7.77	7.76	7.80	7.80	7.80	7.80
USD/TWD	28.20	28.00	28.15	28.30	28.40	28.50
EUR/CNY	9.31	9.30	9.08	8.67	8.40	8.26
EUR/MYR	4.31	4.31	4.23	4.11	4.08	4.06
<b>SGD Crosses</b>	<b>End Q3-11 f</b>	<b>End Q4-11 f</b>	<b>End Q1-12</b>	<b>End Q2-12 f</b>	<b>End Q3-12 f</b>	<b>End Q4-12 f</b>
100 JPY/SGD	1.5093	1.4938	1.4815	1.4405	1.4294	1.4186
EUR/SGD	1.7618	1.7447	1.7280	1.6819	1.6524	1.6470
GBP/SGD	1.9926	1.9718	1.9800	1.9844	1.9805	1.9642
AUD/SGD	1.2758	1.2309	1.2240	1.2221	1.2029	1.1956
NZD/SGD	0.9902	0.9680	0.9600	0.9438	0.9234	0.9150
SGD/MYR	2.4444	2.4686	2.4500	2.4463	2.4691	2.4672
SGD/IDR	6996	7071	7125	7107	7160	7213
SGD/THB	24.44	24.69	23.33	23.55	23.66	23.77
SGD/PHP	34.98	35.15	35.42	35.54	35.80	35.86
SGD/CNY	5.28	5.33	5.25	5.16	5.08	5.01
SGD/HKD	6.40	6.49	6.50	6.45	6.42	6.39
SGD/TWD	23.21	23.43	23.46	23.39	23.37	23.36

Source: Maybank FX Research

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